NATIONAL RATING AGENCY

NRA's Research on the Current State of Russian Regions' Public Debt for the 8 Months of 2016

- ***Since the beginning of the year, the aggregate public debt of the Russian regions has slightly decreased****, whereas the debt structure has changed markedly, with commercial loans further replaced with budget loans;*
- ***The share of bank loans in the total regional governments' debt continues to decline quite noticeably;***
- ***The Russian regions' stratification by the quality of debt management practices continues to extend****: 39 regions have increased and 40 regions have decreased their public debt;*
- ***Around a dozen of regional governments are in the red,*** *experiencing both a fiscal deficit and a high debt burden, and this problem has been getting worse in the past three years. The solution will soon be impossible without radical actions by the federal government;*
- ***Regional governments*** *with the highest debt burden and persistent fiscal deficit* ***continue to build up their public debt,*** *mainly at the expense of budget loans;*
- ***Regional governments fail to meet the budget loan issuance terms****;*
- *The Ministry of Finance's decision to introduce a public debt management rating and a floating interest rate on loans to regions is* ***meant to enhance the effectiveness of the budget loan use by regional governments*** *and improve the payment discipline;*
- *If the new version of the Budget Code were put in force now, then 25 out of* ***85 regional governments would be found unstable in terms of their public debt situation***

Over the 8 months ended 31th August 2016, the Russian regions' aggregate public debt decreased by 2.28 percent to RUB 2.267 trillion. Total budget lending of the Russian regions exceeded RUB 1.1 trillion in September 2016. At the same time, the aggregate public debt has markedly changed structurally. Currently, budget loans are the public debt main component (their share has grown to 48.95 percent in September from around 34.88 percent in early 2016).

On the contrary, commercial loans have lost their role of the regional governments' key debt instruments: their share of the total debt has declined to 29.22 percent in September from 41.64 percent in the beginning of 2016. The total amount of loans issued by banks to the regional governments was RUB 0.662 trillion in early September 2016.

Type of debt	Share as of Jan. 1,.2016	Share as of Sep. 1,.2016	Change in the share (%)
Budget loans	34.88%	48.95%	+14.07
Commercial loans	41.64%	29.22%	-12.42
Securities (bonds)	18.66%	17.15%	-1.51
Federal guarantees	4.44%	4.29%	-0.51
Other	0.38%	0.38%	-

*Table 01 –Russian regional governments' debt over 8 months ended 31th Aug. 2016. (**Sources: Russia's Ministry of Finance; NRA calculations**)*

Debt burden indicators of different regions show a mixed picture: 40 regions have reduced, 39 regions have increased, and six regions have kept unchanged their debt level (two regions, *Sevastopol and Sakhalin Oblast*, have kept their debt at a zero).

Historically, the regional public debt increases at the end of a year, when regional governments need additional funds to finance their fiscal deficits and fulfill their fiscal responsibilities. For this reason, saying that the regional governments' debt has been frozen, or even has reduced would be premature. As to the regional fiscal gap problem, it remains highly relevant, as 52 out of 85 Russian regions ran a collective budget deficit of RUR 0.109 trillion. A large part of this debt is expected to be repaid by issuing new debt.

1. The bank loans-/ total regional governments' debt ratio continues to decline

67 out of 85 Russian regional governments were using bank loans in September 2016. The share of bank loans in the total regional governments' debt varies from 3.4 percent in Novgorod Oblast to 100 percent in Nenets Autonomous Okrug (AO).

Banks providing lending services to Russian regions intended to cut back the financing of local and regional governments (LRGs) in 2015, and some actually were doing so (loan repayment rates were higher than new loan issuance rates). But currently banks admit that lending to low-risk borrowers (such as regional governments) is getting more lucrative and therefore more attractive in the context of growing interest rates, allowing bank managers to revise their plans to cut back the LRGs lending. Moreover, banks are planning to enhance the profitability of the 'loans to governments' business and are looking at customers from the LRG sector to add to their 'passive' customer base by offering marginal interest rates.

It should be pointed out that loans to governments have minimum impact on the bank's capital ratios, as the risk factor applied for calculating the capital charge is the lowest.

Rank	Region	Outstanding bank loans as of Sep. 1, 2016 (billion rubles)
1	Krasnodar Krai	59.8
2	Moscow Oblast	37.8
3	City of Moscow	29.5
4	Rostov Oblast	28.8
5	Sverdlovsk Oblast	27.7
6	Yamal-Nenets Autonomous Okrug	25.7
7	Kemerovo Oblast	25.4
8	Saratov Oblast	24.1
9	Udmurt Republic	20.6
10	Samara Oblast	19.7

Table 02 – 10 regional governments raising largest amounts of bank loans (Source: Russia's Ministry of Finance)

State-owned banks account for a lion's share of the total outstanding bank loans to the regional governments. The biggest lender is *Sberbank*, accounting for around 75 percent of total outstanding commercial loans. The second biggest lender is VTB (12 percent). Banks, such as *Sovcombank, SME-Bank, Vozrozhdenie*, and *Rosselkhozbank* account for the rest. Interest rates on loans issued to the regions are varying from 10 to 12.5 percent p.a. depending on a loan term and size and individual region's characteristics.

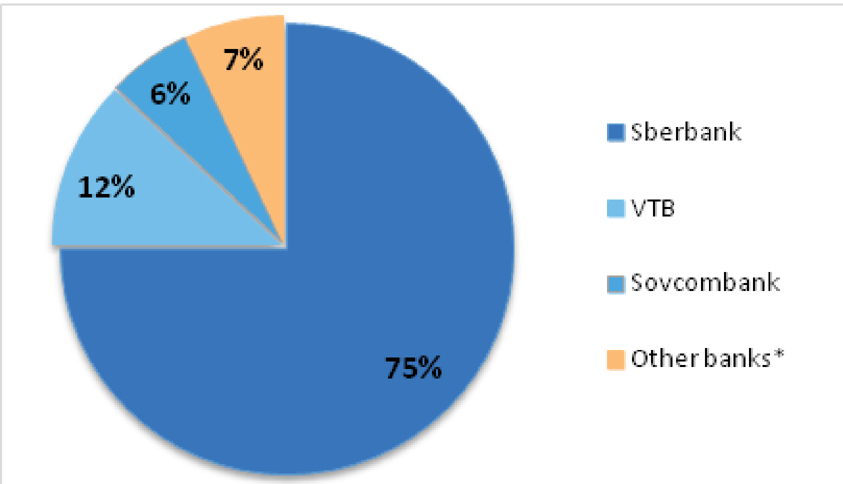

Fig. 01 – Shares of banks in total outstanding loans to Russian regional government as of September 2016 (Source: Banks' financial statements and information)

Despite the policy's intentions for replacing commercial loans with budget loans, it would be premature to say that this part of the debt market is are getting annihilated. Mikhail Chachin, Head of the Regional Finance Supervision Department of *Sberbank*' said in late September that lending to LRGs is bound to grow. This optimistic viewpoint rests on the fact that the regional governments' continue to apply for bank loans, and that *Sberbank* has been a successful bidder in relevant tenders. For example, in late September, *Sberbank* won a tender to issue a loan (up to RUB 4 bn) to the Yamal-Nenets AO that needed to cover its budget deficit. Sberbank's the interest rates on the loan was 11.23 percent p.a.

Information about a number of government tenders to provide loans to Volgograd Oblast was published on a special public government website on the 3rd October 2016. Volgograd Oblast intends to raise RUB 5.6 bn in debt. A successful bidder is expected to provide the required amount to the region at a 12 percent interest rate before the end of 2016. On the same data, the Sakha (Yakutia) Republic published 3 applications for commercial bank loans (a total of RUR 1.6 bn) on its financial ministry's website. The republic is planning to raise the loans at 12.31 percent p.a. and repay the loans in the next three years.

With state-owned banks being the main lenders of the LRGs, the Russian Government and the Ministry of Finance (MoF) are paying much attention to this sector, as evidenced by their efforts to regulate the lending rates. Under a May 2014 agreement between MoF and a group of state-owned banks (*VTB, Sberbank and Rosselkhozbank)*, the banks were to grant credit facilities to regional government at a rate not exceeding the key rate of the Central Bank of Russia (CBR) plus 1.25 percent percentage points. A year later, in April 2015, the terms and conditions of this agreement became more flexible, and the banks agreed not to issue loans at rates higher than 17.5 percent p.a. and not to revise the rates on outstanding loans.

In real event, these agreements were rather informal and not institutionalized. The situation changed on 6th October 2016, when the Russian Government signed Decree #1009, introducing a mechanism for setting a floating rate on bank loans to LRGs. The interest rate was to be calculated as the total of the CBR key rate and a fixed markup, specified in a loan agreement between a bank and a local/ regional government.

As a matter of fact, the interest rate on a bank loan to a regional government is currently tied to the CBR key rate. If the latter is reduced, the loan to a regional government will by default become cheaper.

2. Around a dozen of regional governments are in the 'red' area, experiencing both a fiscal deficit and a high debt burden, a problem that has been getting worse in the past three years. The solution will soon be impossible without radical actions by the federal government.

The chronic fiscal deficit and high debt burden problems are interconnected: it is usually the budget deficit that makes a region resort to borrowing. Borrowing is not the only way to cover a fiscal gap, but other efforts (such as the tax base extension, improved administration of tax and nontax collection efforts, expenditure optimization) may take time and may appear ineffective in adverse macroeconomic circumstances. Most of the regions with fiscal deficits and high debt are characterized by low economic potential and poor investment attractiveness. They have been historically dependent on the federal government.

Regions with the highest fiscal deficit (more than 10 percent of total revenues) *include Nenets AO, Khakassia, Mordovia, Yaroslavl Oblast, Sevastopol, Kostroma Oblast, Karelia, Orel Oblast, Astrakhan Oblast, Crimea, Zabaykalsky Krai, Arkhangelsk Oblast, Kirov Oblast, the Komi Republic, Magadan Oblast, Kabardino-Balkaria, and Mari El.*

The most indebted regions (a debt-to-revenue ratio of 100 percent and higher) *are Amur Oblast, Kaluga Oblast, the Udmurt Republic, Saratov Oblast, Kirov Oblast, Pskov Oblast, Kalmykia, Smolensk Oblast, Northern Ossetia, Arkhangelsk Oblast, Khakassia, and Mordovia.*

Seven regions that we believe to be "in red" (facing the most difficult debt and fiscal situation) ***experienced debt burden increases in the period between January and September:***

Region	Budget deficit (%)	Public debt-to total-revenue ratio (%)	Public debt growth over 8 months 2016 (%)
Mordovia	-22.3	194.1	10.7
Khakassia	-43.6	159.2	28.1
Astrakhan Oblast	-15.6	131.7	9.8
Karelia	-17.3	119.4	1.6
Mari El	-10.2	117.1	10.5
Zabaykalsky Krai	-13.7	111.6	6.9
Kirov Oblast	-13.2	105.7	16.3

Table 03 – Regions in the 'red' area (experiencing high fiscal deficit + high public debt + growing public debt in 2016). Sources: Russia's Ministry of Finance, Statistics Service, Federal Treasury, NRA calculations

3. Several Russian regions managed to remain financially stable during the crisis and stay in the 'green' area, showing a stable fiscal surplus and low debt burden.

"Commodity-producing regions" and "metropolitan areas" are the best-performing Russian regions in the current macroeconomic environment. Despite the general weakening of the investment activity and persistently low oil prices, these regions manage to preserve their financial sustainability. They continue to collect large tax revenues from incumbent businesses, covering their operating expenditures. They keep running budget surpluses and have no need to use debt instruments. The only exceptions are Sevastopol and Crimea, whose low debt has nothing to do with financial sustainability and is only due to grants transferred by the federal government.

Regions without fiscal problems, (with budget surpluses greater than 10 percent of total revenues) include Sakhalin Oblast, Tyumen Oblast, Leningrad Oblast, Moscow, Khanty-Mansi AO, Chukotka AO, Yamal-Nenets AO, and Bashkortostan.

Regions without debt problems, (with debt-to total-revenue ratio of less than 10 percent) include Sevastopol, Sakhalin Oblast, Tyumen Oblast, Crimea, St Petersburg, Altai Krai, Moscow, Khanty-Mansi AO, Vladimir Oblast, Leningrad Oblast, and Primorsky Krai.

Four Russian regions consistently find themselves 'in the green' (a stable financial position in terms of debt burden and budget). Although they can afford some debt increase, they did not use this opportunity in the period from January to September, except for two regions, Tyumen Oblast and Khanty-Mansi AO, while Moscow decreased its debt, and Sakhalin Oblast kept its debt at a zero:

Region	Budget surplus (%)	Public debt-to-total-revenue ratio (%)	Public debt growth over 8 months 2016 (%)
Sakhalin Oblast	+54,0%	0,0%	0,0%
Tyumen Oblast	+22,7%	1,4%	+45,8%
City of Moscow	+20,3%	6,5%	-23,2%
Khanty-Mansi AO,	+15,5%	7,6%	+9,7%

Table 04 – Regions in the 'green' area (high fiscal surplus + low public debt). Sources: Russia's Ministry of Finance, Statistics Service, Federal Treasury, NRA calculations

4. Russian regions with the highest debt burden and a chronic fiscal deficit continue to build up their public debt, mainly at the expense of budget loans.

Federal authorities including MoF, Federation Council and State Duma, have long been discussing ways of financially rehabilitating the most indebted regional governments. One proposed solution is the replacement of commercial loans with budget ones. The idea is that a lower debt service on budget loans (granted at 0.1 percent p.a.) will allow the regions to slowly acquire funds to repay the principal debt. However, this does not happen in real life, and the replacement of banks' commercial loans with budget loans does not result in any alleviation of the 'problem' regions' debt burden (moreover, their debt burden keeps growing).

The increase in the 'problem' regions' debt may be related to the regions' perception of budget loans as additional federal funds available for operating costs, rather than tools to restructure their debt. As a matter of fact, ***regional debt is being converted from a debt instrument into an additional mechanism for getting central government transfers***, only differing from subsidies and grants in that they are made for charge. However, since rates on budget loans are very low, these loans may be regarded as interest-free. The only encumbrance for a recipient region is the agreement with MoF, obliging it to comply with certain fiscal covenants. In practice, these fiscal targets are not generally achieved.

5. Regional governments fail to meet the budget loan issuance terms.

In September, MoF published a report summarizing the results of financial monitoring of Russian regional governments in 2015. According to MoF, 14 regions receiving budget loans intended for repayment of their market debt violate the terms of the loans, with half of them (seven out of 14) failing to comply for the second year running. The "obstinately disobedient" regions included *Zabaykalsky Krai, Krasnodar Krai, Pskov Oblast, Mari El, Mordovia, and Khakassia*. MoF referred them to regions "with weak financial management systems" by default.

So far, MoF has not been using other sanctions for persistent non-compliance with budget loan terms. It only informs the regions about its assessment of their financial management quality and provides recommendations on measures to enhance performance in this area. But going forward, MoF may decide to suspend or cut back the lending of non-complying regions. As a matter of fact, such regions, failing to strengthened their financial systems, cannot use budget loans to solve their fiscal deficit and debt burden problems.

6. If the new Budget Code version were put in force now, then 25 out of 85 regional governments would be found unstable in terms of their public debt situation

The new Budget Code version, to be put in force in 2019, classifies Russian regions into three groups ranging from those with a strong debt stainability (a debt-to-total-revenue ratio of less than 50 percent) to those with a moderate debt stainability (a debt-to-total-revenue ratio of 50-85 percent) to those with a weak debt stainability.

If the new Budget Code rules were put in force now, then, by the beginning of September 2016, 25 out of 85 regional governments would be referred to those with weak debt stainability.

№	Region	Public debt-to tax& nontax revenues (%)	Change in the debt level during 01.01-01.09 2016 (%)
1	Republic of Mordovia*	194,1%	+10,7%
2	Republic of Khakassia*	159,2%	+28,1%
3	Kostroma Oblast	148,8%	+9,6%
4	Republic of North Ossetia-Alania	134,8%	+20,5%
5	Astrakhan Oblast	131,7%	+9,8%
6	Republic of Kalmykia	122,1%	+24,0%
7	Republic of Karelia	119,4%	+1,6%
8	Republic of Mari-El*	117,1%	+10,5%
9	Zabaykalsky Krai*	111,6%	+6,9%
10	Pskov Oblast*	106,5%	+8,8%
11	Kirov Oblast*	105,7%	+16,3%
12	Smolensk Oblast*	104,3%	-7,6%

№	Region	Public debt-to tax& nontax revenues (%)	Change in the debt level during 01.01-01.09 2016 (%)
13	Kaluga Oblast	104,3%	+11,9%
14	Karachay-Cherkess Republic	102,7%	+13,5%
15	Saratov Oblast	98,3%	0,0%
16	Orel Oblast*	97,8%	+13,1%
17	Udmurt Republic,	97,4%	+7,8%
18	Amur Oblast	97,2%	+2,6%
19	Belgorod Oblast	95,8%	0,0%
20	Krasnodar Krai*	94,9%	-0,5%
21	Ryazan Oblast	92,8%	+2,2%
22	Vologda Oblast	89,9%	+2,2%
23	Ivanovo Oblast*	87,1%	-4,2%
24	Volgograd Oblast	85,8%	+1,8%
25	Yaroslavl Oblast*	85,5%	+17,1%

- region not complying with the Budget Loan Agreement with MoF

Table. 05. Regions with debt exceeding 85 percent of total revenue (Sources: Russia's Ministry of Finance, Statistics Service, Federal Treasury, NRA calculations)

Only three out of 25 regions with debt exceeding 85 percent of total revenues managed to reduce their debt burden, and two regions managed to keep their debt burden unchanged in January-September 2016. The rest 20 regions kept building up their debt. Eleven out of those 25 regions have weak financial management systems or violate the budget loan agreement, according to MoF.

Situation in less indebted regions was reviewed for comparison purposes. The 25 percent debt-to-total-revenue threshold ratio was used as a criterion. 14 regions were found to have a low debt burden in the beginning of September.

№	Region	Public debt-to tax& nontax revenues as of Sep. 1, 2016 (%)	Change in the debt level during 01.01-01.09 2016 (%)	Financial management quality + budget loan compliance
1	Sevastopol	0%	0,0%	NA
2	Sakhalin Oblast	0%	0,0%	Strong
3	Tyumen Oblast	1,4%	+45,8%	Adequate
4	Republic of Crimea	1,9%	-17,0%	NA
5	St Petersburg	3,4%	0,0%	Strong
6	Altai Krai	5,6%	-0,2%	Strong
7	Moscow	6,5%	-23,2%	Strong
8	Khanty-Mansi Autonomous Region	7,6%	+9,7%	Strong
9	Vladimir Oblast	9,5%	-14,0%	Strong
10	Leningrad Oblast	9,7%	-0,7%	Strong
11	Primorsky Krai	9,7%	-19,4%	Adequate
12	Irkutsk Oblast	14,1%	-40,9%	Strong

№	Region	Public debt-to tax& nontax revenues as of Sep. 1, 2016 (%)	Change in the debt level during 01.01-01.09 2016 (%)	Financial management quality + budget loan compliance
13	Perm Krai	20,6%	-11,9%	Strong
14	Republic of Bashkortostan	22,2%	+4,8%	Strong

NA – estimate not available

Table 06. Regions with debt lower than 25 percent of total revenue (Sources: Russia's Ministry of Finance, Statistics Service, Federal Treasury, NRA calculations)

Eight out of 14 regions with debt lower than 25 percent of total revenues reduced their debt burden, and three regions (including two with a zero debt) kept their debt burden unchanged in January-September 2016. The rest three regions kept building up their debt. Almost all of those regions have strong financial management practices and comply with MoF requirements.

NRA's Analytical Department

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NATIONAL RATING AGENCY

32A, Khoroshevskoe shosse, Moscow, 123007
Tel/Fax: +7 (495) 775-59-02, 775-59-01
www.ra-national.ru

Individual Ratings
Customer Service: +7 (495) 775-59-02 #113, 117, 120
info@ra-national.ru

Rankings and non-interactive ratings
Analytical Department: +7 (495) 775-59-02 #110
info@ra-national.ru

Information sharing, participation in conferences
Public Relations Department: +7 (495) 775-59-02 #104,115
pr@ra-national.ru